

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AC01

Investment of Customer Funds

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission”) is amending its regulations to allow futures commission merchants (“FCMs”) and derivatives clearing organizations (“DCOs”) to engage in repurchase agreements (“repos”) with securities deposited by customers, subject to certain conditions, and to modify the portfolio time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs, pursuant to certain conditions.

EFFECTIVE DATE: [INSERT DATE [30] DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER.]

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SUPPLEMENTARY INFORMATION:

I. Background

Commission Rule 1.25 (17 CFR 1.25) sets forth the types of instruments in which FCMs and DCOs are permitted to invest customer segregated funds. Rule 1.25 was

substantially amended in December 2000 to expand the list of permitted investments.¹ In connection with that expansion, the Commission added several provisions intended to minimize the credit, liquidity, and volatility risks associated with the additional investments.

On June 30, 2003, the Commission published for public comment proposed amendments to some of those provisions and further requested comment on several other provisions of the rule.² The Commission received comment letters from the Futures Industry Association (“FIA”), National Futures Association (“NFA”), Chicago Mercantile Exchange (“CME”), Federal Home Loan Mortgage Corporation (“Freddie Mac”), and Lehman Brothers. In light of the comments received, the Commission has determined to adopt amendments to Rule 1.25 substantially as proposed and to further clarify certain provisions of the rule.³

II. Discussion of the Final Rules

A. Repurchase Agreements Involving Collateral Deposited by Customers

CFTC Staff Letter 84-24 (“Letter 84-24”)⁴ permits FCMs to enter into repos with collateral deposited by customers (“customer collateral”), subject to certain terms and

¹ See 65 FR 77993 (Dec. 13, 2000) (publishing final rules); 65 FR 82270 (Dec. 28, 2000) (making technical corrections and accelerating effective date of final rules from February 12, 2001 to December 28, 2000).

² See 68 FR 38654 (June 30, 2003). In a separate release, the Commission will address comments received on aspects of Rule 1.25 that were not related to textual amendments proposed in the June 30, 2003 Federal Register release.

³ The Commission is also making technical revisions in that the final rules consistently use the term “derivatives clearing organization,” rather than the terms “clearing organization” or “registered clearing organization,” as had appeared in the text of the proposed rules.

⁴ CFTC Staff Letter No. 84-24, [1984-1986 Transfer Binder] Comm. Fut. L. Rep.
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conditions. When the Commission adopted the amendments to Rule 1.25 in December 2000, it included provisions governing repos and reverse repos involving investments purchased with customer funds (“permitted investments”), subject to terms and conditions that differ in a number of ways from those in Letter 84-24.⁵ The Commission did not, however, specifically address Letter 84-24 at that time.

The Commission proposed to amend Rule 1.25(a)(2) to permit FCMs and DCOs to engage in repos of customer-deposited securities subject to certain terms and conditions. The proposed amendments did not include a requirement that the FCM provide written disclosure of the mechanics of the repo transaction and obtain prior written authorization from the customer. In contrast, Letter 84-24 does include such a requirement. The Commission requested public comment on whether it is appropriate to permit repos of customer collateral without prior written consent, and, if so, whether the limitations set forth in the proposal are appropriate. The Commission further requested comment on whether one-way notice disclosure to the customer should be required, or whether an “opt-out” mechanism should be provided.

The Commission received three comments on the disclosure issue. The FIA pointed out that the securities used in the repos would have to be highly liquid and any loss incurred as a result of a counterparty default would be borne by the FCM. The FIA therefore concluded that the Commission should not require an FCM to provide one-way disclosure or obtain a customer’s written consent prior to engaging in a repo transaction

(CCH) ¶ 22,449 (Dec. 5, 1984).

⁵ See Rule 1.25(a)(2) and Rule 1.25(d).

with the customer's securities. It further stated its view that all customers are presumed to be aware of the rules and regulations governing their accounts.⁶

The NFA observed that because the Commission's proposed amendments exclude specifically identifiable property from repo transactions, it is not necessary to provide an opt-out mechanism whereby a customer could instruct an FCM not to subject collateral to a repo. The NFA expressed its belief that an opt-out provision would be costly and burdensome for FCMs that would have to revise their existing customer agreements without a corresponding regulatory benefit.

Freddie Mac expressed the contrary view that the written disclosure and customer consent requirements of Letter 84-24 are appropriate, and should be retained. It pointed out that, in posting margin to its clearing firms, Freddie Mac may transfer securities, which may include mortgage-related securities that are not fungible. In certain cases, it may be necessary to have the same security returned in order to achieve the company's asset/liability management goals or for other risk management purposes. Freddie Mac stated that, at a minimum, customers and FCMs should be permitted to provide contractually for disclosure and notice.

The Commission has determined to amend Rule 1.25(a)(2) as proposed, without a requirement for written disclosure and customer consent. The Commission believes that in light of the stringent safeguards discussed below, it is appropriate to provide FCMs and DCOs this additional flexibility in performing collateral management. The Commission wishes to emphasize, however, that the absence of disclosure and consent

⁶ Lehman Brothers stated in its comment letter that it fully supports the views set forth in the FIA's comment letter.

requirements does not preclude any customer of an FCM from requiring on its own initiative, by written agreement (e.g., the customer agreement), that the FCM obtain the customer's prior consent in order to engage in repo transactions with securities deposited by the customer. As in other instances where disclosure and customer authorization are not expressly required by regulation, a customer and its FCM are always free to negotiate terms and conditions of disclosure and consent, and to enter into a binding agreement accordingly.⁷

With respect to the criteria for engaging in repos with customer collateral under proposed paragraphs (a)(2)(ii)(A)-(D), the FIA expressed the view that those requirements, in combination with the requirements of paragraph (d), “will be more than sufficient to safeguard both the customer-owned securities specifically as well as the customer segregated account generally.” Similarly, the NFA observed that the safeguards included in the proposal provide “ample protection” for customer-deposited securities.

Proposed paragraph (a)(2)(ii)(A) would provide that, to be eligible for repurchase, securities would have to meet the marketability requirements of Rule 1.25(b)(1).⁸

⁷ The Commission believes that a customer's ability to negotiate arrangements for disclosure and consent adequately addresses Freddie Mac's concerns. It notes, however, that it is not making any determination as to whether the instruments identified in the Freddie Mac letter would satisfy the standards set forth under paragraph (a)(2)(ii)(A)-(D) (discussed below), thereby making them suitable for repurchase.

⁸ Under Rule 1.25(b)(1), except for interests in money market mutual funds, investments must be “readily marketable” as defined in 17 CFR 240.15c3-1 (the net capital rule of the Securities and Exchange Commission). Paragraph (c)(11)(i) of that rule provides that “[t]he term ready market shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously

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Application of this standard is intended to ensure that, if a repo counterparty should default, the FCM or DCO could use the cash proceeds from the repo to buy the securities elsewhere. Both the NFA and FIA supported the marketability requirement. The Commission has determined to adopt paragraph (a)(2)(ii)(A) as proposed.

Proposed paragraph (a)(2)(ii)(B) would provide that securities subject to repos must not be “specifically identifiable property” as defined in Rule 190.01(kk) (17 CFR 190.01(kk)). Such property is generally not eligible for repurchase. The NFA expressed the opinion that the exclusion of specifically identifiable property eliminates the need to require the FCM to replace the securities in the event of a counterparty default. The NFA further stated its belief that, in the event of a default, it would be acceptable for an FCM to make the customer whole by giving the customer the cash equivalent of the securities plus any transaction costs that might be incurred in replacing the securities. This topic is discussed in connection with paragraph (a)(2)(ii)(D), below. The Commission has determined to adopt paragraph (a)(2)(ii)(B) as proposed.

Proposed paragraph (a)(2)(ii)(C) would provide that the terms and conditions of a repo involving customer-deposited securities must be in accordance with the requirements of Rule 1.25(d).⁹ As noted above, the FIA commented that application of the requirements of paragraph (d), combined with the additional requirements of proposed paragraph (a)(2)(ii), will more than sufficiently safeguard both the customer-

and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.”

⁹ Rule 1.25(d) specifies criteria for repos and reverse repos involving permitted investments. Those criteria address, among other things, identification of securities, permissible counterparties, applicability of concentration limits, duration of the agreement, substitution and transfer of securities, documentation and confirmation

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owned securities and the customer segregated account. The Commission believes that these safeguards, currently applicable to repos for permitted investments, are appropriate to apply to customer-deposited securities as well. The Commission, therefore, has determined to adopt paragraph (a)(2)(ii)(C) as proposed.

Proposed paragraph (a)(2)(ii)(D) would provide that, in the unlikely event of a default by a counterparty to a repo, the FCM or DCO “must take steps to ensure” that the default does not result in “any cost or expense” to the customer. The Commission requested comment on how an FCM might fulfill its obligations to its customer in the event a repo counterparty fails to perform. In this regard, the Commission asked commenters to consider whether it is sufficient for the FCM to give the customer the cash equivalent of the securities, plus any transaction costs that might be incurred in replacing the securities, or whether the FCM should be required to replace the securities. The Commission recognized the possibility that cash compensation might be insufficient if a customer needed the particular securities to maintain the risk profile of its portfolio.

The FIA observed that, among other things, because the customer-owned securities used for repos must be highly liquid, an FCM should have little difficulty using the cash proceeds of the repo held in the customer segregated account to buy the same securities elsewhere. The FIA stated its belief that if a counterparty fails to perform, an FCM should make every reasonable effort to replace the customer-owned securities that are the subject of the repo. The FIA added that “[o]f course, any loss incurred as a result of such difficulty would be borne by the FCM.” In response to the Commission’s specific request for comments on whether there are tax implications that should be

requirements, and bookkeeping requirements.

considered in connection with the proposal, the FIA stated its understanding that the failure of a counterparty to return the customer-owned securities could, in certain circumstances, have tax implications. Given the remoteness of counterparty default, the FIA said it does not believe the Commission should consider potential tax implications in adopting final rules. The Commission received no other comments on tax implications.

As noted above, the NFA stated its view that in the event of a counterparty default, it would be acceptable for an FCM to make the customer whole by giving the customer the cash equivalent of the securities plus any transaction costs that might be incurred in replacing the securities. It noted, however, that replacing the securities may be the preferable course of action.

Freddie Mac, in pointing out that it posts margin in the form of securities that are not fungible, explained that in certain cases, it may be necessary to have the same security returned in order to achieve the company's asset/liability management goals or for other risk management purposes. Based on this concern, Freddie Mac requested that the Commission make more explicit, and specifically state, that an FCM is responsible for losses arising from a customer's inability to maintain the risk profile of a portfolio or otherwise replicate necessary positions (e.g., "breakage"), transactional costs, and similar consequential losses resulting from the repo transaction.

The Commission has determined that in the unlikely event of a counterparty default involving customer-deposited securities, the FCM or DCO must make the customer economically whole and must do so in a timely manner. The FCM or DCO will not be required to replace the securities; rather, it may exercise its discretion in determining the means for making the customer whole in light of the relevant facts and

circumstances. Making the customer “whole” includes, but is not limited to replacing the securities that were the subject of the repo, paying the customer the cash equivalent of the securities, reimbursing the customer for any commissions or other transactional costs incurred by the customer in replacing the securities, compensating the customer for any adverse tax consequences accruing to the customer,¹⁰ or covering any other losses that arise from the counterparty’s failure to return the securities deposited by the customer.

Accordingly, the proposed language of 1.25(a)(2)(ii)(D), which would have obligated the FCM or DCO “to take steps to ensure” that the default by a repo counterparty does not result in “any cost or expense to the customer,” has been revised to read “[u]pon the default by a counterparty to a repurchase agreement, the futures commission merchant or derivatives clearing organization shall act promptly to ensure that the default does not result in any direct or indirect cost or expense to the customer.” This modified language is intended to clarify: (1) the FCM or DCO has an unconditional responsibility to make the customer whole; (2) the FCM or DCO must act promptly; and (3) making the customer whole includes compensation for a wide range of costs and expenses, both direct and indirect, as discussed above.

In its proposal, the Commission requested comment on whether the terms and conditions applicable to DCOs engaging in repos should differ in any way from those

¹⁰ While the FIA has suggested that the Commission need not consider possible tax consequences in its deliberations, the Commission wishes to make clear that adverse tax consequences for customers as a result of a repo counterparty default are the type of cost or expense that must be covered by the FCM. The Commission agrees that it is not necessary to engage in an analysis of specific factual situations that may give rise to adverse tax consequences, but it is necessary to point out that the Commission contemplates that adverse tax consequences are the type of cost or expense for which the customer must be compensated.

applicable to FCMs. The Commission received no comments on this topic. The Commission has determined to apply the same rules to both FCMs and DCOs engaging in repo transactions with customer-deposited securities because the same economic risks apply to both situations.

The Commission also requested comment on whether customer collateral that is subject to repo should be treated for concentration purposes like permitted investments under paragraph (b)(4)(ii) (repurchase agreements) or continue to be treated under paragraph (b)(4)(v) (treatment of customer-owned securities). Only the FIA touched on this. In footnote 3 of its letter, the FIA recommends that the concentration limit requirements in paragraph (b)(4)(i) (permitted investments) apply to all transactions. The Commission notes that under current paragraph (b)(4)(v), there is no concentration requirement for customer-deposited securities because changes in the value of such securities accrue to the customer, not the FCM.¹¹ The final rules in no way limit or alter the fact that changes in the value of such securities accrue to the customer and not the FCM. As discussed above, however, if an FCM engaged in a repo with a customer-deposited security and the counterparty defaulted, the FCM would bear the cost. Thus, the FCM would incur price risk. Accordingly, consistent with the FIA comment, the concentration requirements of direct investments apply.

In light of the Commission's adoption of amendments to Rule 1.25(a)(2), as discussed above, Rule 1.25, as amended, supersedes Letter 84-24.

B. Time-to-Maturity Requirements for Certain Collateral

¹¹ See 65 FR at 78002 (Dec. 13, 2000) (discussion accompanying the Commission's adoption of the concentration requirements).

Rule 1.25(b)(5) establishes a time-to-maturity requirement for the portfolio of permitted investments. In order to encourage development of innovative collateral management programs, and thereby facilitate the efficient use of capital, the Commission proposed to amend Rule 1.25(b)(5) to permit certain instruments to be treated as if they had a time-to-maturity of one day, if certain terms and conditions were satisfied.¹²

The Commission proposed the following criteria for such treatment: first, under proposed paragraph (b)(5)(ii)(A), the instrument must be deposited with a DCO solely on an overnight basis, pursuant to the terms and conditions of a collateral management program. Second, under proposed paragraph (b)(5)(ii)(B), the instrument must be one that the FCM owns or has the unqualified right to pledge, is free of any lien, and is deposited by the FCM into a segregated account at a DCO.¹³ Third, under proposed paragraph (b)(5)(ii)(C), the instrument must be used only for the purpose of meeting concentration margin or other similar charges that are in addition to the basic margin requirement established by the DCO. Fourth, under proposed paragraph (b)(5)(ii)(D), the DCO must price the instrument each day based on the current mark-to-market value.

¹² The proposed amendments to Rule 1.25(b)(5) were intended to address the CME's Interest Earning Facility 3 program ("IEF 3"), and any similar programs, whereby FCMs could deposit certain collateral on an overnight basis to meet concentration margin requirements. Absent amendment of the rule, the deposit of such collateral could cause the FCM's portfolio to exceed the time-to-maturity limits of Rule 1.25(b)(5).

¹³ Instruments given to an FCM by a customer for deposit in a segregated account currently are not subject to the time-to-maturity provisions of Rule 1.25, and this remains the case under the final rules. Instruments purchased by an FCM with customer funds and held in a segregated account currently are subject to those provisions. This generally will remain the case under the final rules. The final rules provide relief with regard to instruments that are held by an FCM in its non-segregated inventory and that are deposited on an overnight basis into a segregated account at a DCO. So long as an FCM has an unqualified right to pledge the instruments, it may include instruments obtained through reverse repos, or otherwise.

Fifth, under proposed paragraph (b)(5)(ii)(E), the DCO must haircut the instrument by at least two percent.

The Commission requested comment on the appropriateness of the proposed terms and conditions. In particular, the Commission requested comment on whether the relief should be limited to instruments deposited to meet concentration and similar margin requirements, as proposed, or whether the modified treatment should be extended to apply to initial margin generally. If the latter, the Commission requested comment on whether alternative safeguards should be developed. The Commission also requested comment on whether the proposed haircut is appropriate.

The Commission received two comment letters on the proposed amendments to Rule 1.25(b)(5). With respect to the permitted categories of margin (proposed paragraph (b)(5)(ii)(C)), the CME requested clarification that the proposed language would not restrict it from applying assets in the IEF 3 program to reserve and/or core performance bond requirements. The CME stated that it performs its own conservative risk management and stress testing functions on a daily basis, establishing a prudent and flexible program that benefits market participants. It asserted that by expanding the list of permitted margin categories, industry participants and DCOs would realize greater benefits. The CME stated its belief that it is important to have the flexibility to expand the IEF 3 program to satisfy other classes of performance bond requirements.

Similarly, the FIA expressed the view that certain of the proposed terms and conditions would unnecessarily restrict the scope of the relief. In particular, the FIA stated its belief that the benefits of the amendment should not be limited to those circumstances in which the securities are used only for the purpose of meeting

concentration margin or other similar charges. Referring to the IEF 3 program, the FIA noted that although it is limited to the deposit of concentration margin, “we see no reason why, if a clearing organization desired, a comparable program could not be designed for initial margin deposits generally.”

With respect to the proposed minimum haircut of two percent (proposed paragraph (b)(5)(ii)(E)), the CME expressed the view that the rule should allow either a DCO or a qualified custodian to perform the pricing and haircutting functions. It indicated that it plans to use third party custodians to price and haircut securities that qualify for the one-day time-to-maturity benefit, but would like the ability to perform these functions if it obtains the necessary expertise. The CME did not object to the two percent minimum haircut.

The FIA opposed the minimum haircut, expressing the view that the DCO core principles support the authority of DCOs to exercise discretion in managing risks in setting haircuts on deposited securities. The FIA requested that the Commission defer to the DCO’s judgment in establishing such haircuts, until the Commission has reason to believe that the DCO is not complying with a core principle.

The Commission has carefully considered the views expressed by the CME and FIA. The Commission has determined to adopt the amendments to Rule 1.25(b)(5), as proposed, with two exceptions. First, the Commission has decided not to adopt proposed paragraph (b)(5)(ii)(C), which would have limited the one-day time-to-maturity treatment to instruments deposited to meet concentration margin or similar charges. The Commission believes that the other provisions of the rule constitute prudent safeguards

and that it is appropriate to give DCOs the flexibility to apply the rule to other classes of performance bond.

Second, in the final rules, the Commission has added language to proposed paragraph (b)(5)(ii)(A) to make clear that the DCO's collateral management program must have become effective in accordance with the notice procedures of Rule 39.4.¹⁴ The notice procedures, which apply generally to DCO rules,¹⁵ provide the Commission with a mechanism for maintaining an appropriate level of oversight to ensure that the relief granted in paragraph (b)(5) is applied consistent with core principles and the Commission's regulations. The Commission notes that rather than adopt prescriptive rules for collateral management programs that incorporate the one-day time-to maturity treatment, the Commission has taken a more flexible approach in permitting DCOs to exercise discretion in developing such programs.

With regard to the CME's comment on performance of the pricing and haircutting function, the Commission confirms that a DCO could outsource the daily execution of these functions to a third party custodian. Under the rule, however, the DCO would remain ultimately responsible for compliance.

With regard to the FIA's comment on the haircut, the Commission has decided to impose a minimum two percent haircut, as proposed. The effect of new paragraph (b)(5)(ii) will be to give relief from the time-to-maturity requirement of paragraph

¹⁴ Rule 39.4(a) provides that DCOs may request Commission approval for rules and rule amendments under Rule 40.5, and Rule 39.4(b) provides that DCOs may self-certify new or amended rules under Rule 40.6.

¹⁵ The Commission broadly defines the term "rule" to include, among other things, rules, regulations, interpretations, and stated policies, in whatever form adopted, and any amendment or addition thereto, made or issued by a DCO. See Rule 40.1.

(b)(5)(i) that would otherwise apply. The Commission believes that in light of this relief, the two percent haircut is a prudent substitute safeguard. The Commission understands that two percent is the standard haircut generally used in the repo market.

Finally, the FIA concluded its comments on (b)(5) with a request for the Commission to confirm that, to the extent the concentration limits in Rule 1.25 apply to deposits of securities with DCOs under 1.25(b)(2), the applicable limits will be the limits for direct investments. The Commission hereby confirms this.

III. Section 4(c) Findings

The final rules allowing FCMs and DCOs to engage in repos with securities deposited by customers are promulgated under Section 4d(a)(2) of the Commodity Exchange Act (“Act”),¹⁶ which governs investment of customer funds, and Section 4(c) of the Act,¹⁷ which grants the Commission broad exemptive authority. Section 4d(a)(2) provides that customer funds may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States. It further provides that such investments must be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.

Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission, by rule, regulation or order, may exempt any class of agreements, contracts or transactions, including any person or class of persons offering, entering into, rendering advice or rendering other services with

¹⁶ 7 U.S.C. 6d(a)(2).

¹⁷ 7 U.S.C. 6(c).

respect to, the agreement, contract, or transaction, from the contract market designation requirement of Section 4(a) of the Act, or any other provision of the Act other than Section 2(a)(1)(C)(ii) or (D), if the Commission determines that the exemption would be consistent with the public interest. For the reasons stated below, the Commission believes that issuing the exemptive relief as set forth in these final rules is consistent with the public interest.

The Commission is expanding the range of instruments in which FCMs may invest customer funds beyond those listed in Section 4d(a)(2) of the Act, to enhance the yield available to FCMs, DCOs, and their customers without compromising the safety of customer funds. These final rules should enable FCMs and DCOs to remain competitive globally and domestically, while maintaining safeguards against systemic risk. In light of the foregoing, the Commission has determined that the adoption of the final rules regarding the expansion of permitted instruments for the investment of customer funds will be consistent with the “public interest,” as that term is used in Section 4(c) of the Act. When that provision was enacted, the Conference Report accompanying the Futures Trading Practices Act of 1992¹⁸ stated that the “public interest” in this context would “include the national public interests noted in the Act, the prevention of fraud and the preservation of the financial integrity of the markets, as well as the promotion of responsible economic or financial innovation and fair competition.”¹⁹

¹⁸ Pub. L. No. 102-546, 106 Stat. 3590 (1992).

¹⁹ H.R. Conf. Rep. No. 102-978 (1992). The Conference Report also states that the reference in Section 4(c) to the “purposes of the Act” is intended to “underscore [the Conferees’] expectation that the Commission will assess the impact of a proposed exemption on the maintenance of the integrity and soundness of markets and market participants.” Id.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”)²⁰ requires federal agencies, in promulgating rules, to consider the impact of those rules on small businesses. The rule amendments adopted herein will affect FCMs and DCOs. The Commission has previously established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.²¹ The Commission has previously determined that registered FCMs²² and DCOs²³ are not small entities for the purpose of the RFA. Pursuant to 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that the final rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (“PRA”)²⁴ imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The final rule amendments that have been adopted do not require a new collection of information on the part of any entities subject to these rules.

C. Cost-Benefit Analysis

Section 15(a) of the Act requires that the Commission, before promulgating a

²⁰ 5 U.S.C. 601 et seq.

²¹ 47 FR 18618 (Apr. 30, 1982).

²² Id. at 18619.

²³ 66 FR 45604, 45609 (Aug. 29, 2001).

regulation under the Act or issuing an order, consider the costs and benefits of its action. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of a new rule or determine whether the benefits of the rule outweigh its costs. Rather, Section 15(a) simply requires the Commission to “consider the costs and benefits” of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of the following considerations: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any one of the five considerations and could, in its discretion, determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Commission has evaluated the costs and benefits of the final rules in light of the specific considerations identified in Section 15(a) of the Act, as follows:

1. Protection of market participants and the public. The final rules facilitate greater capital efficiency on the part of FCMs and DCOs, while protecting customers by establishing prudent standards for repos with customer-deposited collateral and requirements for adjustment to time-to-maturity calculations for certain collateral management programs.

²⁴ 44 U.S.C. 3507.

2. Efficiency and competition. The final rules provide FCMs and DCOs with greater flexibility in using repos to maximize returns on direct investment of customer funds. They also facilitate the implementation of collateral management programs, which can also serve to maximize capital efficiency. The rules should enable FCMs and DCOs to remain competitive globally and domestically, while maintaining safeguards against systemic risk.

3. Financial integrity of futures markets and price discovery. The final rules will not affect the financial integrity of futures markets and price discovery.

4. Sound risk management practices. The final rules impose sound risk management practices for FCMs and DCOs that elect to invest customer funds under the rules. The rules regarding repos with customer-deposited securities make clear that FCMs and DCOs, not customers, will bear the costs of any default by a repo counterparty. DCOs acting pursuant to the one-day time-to-maturity relief must satisfy the requirements set forth in the final rules, which include a requirement that the governing collateral management program must have been filed with the Commission.

5. Other public considerations. The final rules are expected to enhance the ability of FCMs and DCOs to earn revenue from the investment of customer funds, while protecting the safety of such funds and preserving the rights of customers. FCMs and DCOs are not obligated to enter into repos with customer-deposited collateral under Rule 1.25(a)(2), and, similarly, DCOs are not obligated to implement collateral management programs applying the relief granted in Rule 1.25(b)(5). Therefore, any costs to FCMs and DCOs in connection with the implementation of these rules are voluntarily incurred. With respect to customer costs, the rules clarify that, in the case of a default by a repo

counterparty, the customer must be made whole, promptly. The requirements that must be satisfied in order for collateral to be used for a repo (including ready marketability) will make prompt replacement of the securities or payment of replacement costs readily feasible solutions.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and Recordkeeping requirements.

PART 1--GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C.

2. Section 1.25 is amended by revising paragraphs (a)(2) and (b)(5) to read as follows:

Sec. 1.25 Investment of customer funds.

(a) * * *

(2)(i) In addition, a futures commission merchant or derivatives clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the instruments, in accordance with the provisions of paragraph (d) of this section.

(ii) A futures commission merchant or a derivatives clearing organization may sell securities deposited by customers as margin pursuant to agreements to repurchase subject to the following:

(A) Securities subject to such repurchase agreements must meet the marketability requirement of paragraph (b)(1) of this section.

(B) Securities subject to such repurchase agreements must not be “specifically identifiable property” as defined in § 190.01(kk) of this chapter.

(C) The terms and conditions of such an agreement to repurchase must be in accordance with the provisions of paragraph (d) of this section.

(D) Upon the default by a counterparty to a repurchase agreement, the futures commission merchant or derivatives clearing organization shall act promptly to ensure that the default does not result in any direct or indirect cost or expense to the customer.

(b) * * *

(5) Time-to-maturity. (i) Except for investments in money market mutual funds, the dollar-weighted average of the time-to-maturity of the portfolio, as that average is computed pursuant to § 270.2a-7 of this title, may not exceed 24 months.

(ii) For purposes of determining the time-to-maturity of the portfolio, an instrument that is set forth in paragraphs (a)(1)(i) through (vii) of this section may be treated as having a one-day time-to-maturity if the following terms and conditions are satisfied:

(A) The instrument is deposited solely on an overnight basis with a derivatives clearing organization pursuant to the terms and conditions of a collateral management program that has become effective in accordance with § 39.4 of this chapter;

(B) The instrument is one that the futures commission merchant owns or has an unqualified right to pledge, is not subject to any lien, and is deposited by the futures commission merchant into a segregated account at a derivatives clearing organization;

(C) The derivatives clearing organization prices the instrument each day based on the current mark-to-market value; and

(D) The derivatives clearing organization reduces the assigned value of the instrument each day by a haircut of at least 2 percent.

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Jean A. Webb,

Secretary of the Commission.